

DEPARTMENT OF TRANSPORTATION**AUDITS AND INVESTIGATIONS**

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September 12, 2008

Mr. Robert J. Carlson, Deputy Director for Financial
Management and Administration
City and County of San Francisco,
Department Of Public Works
30 Van Ness Avenue, 5th floor
San Francisco, CA 94102

Re: City and County of San Francisco, Department of Public Works
Audit of Indirect Cost Rate Proposal for FY 2006/07
File No: P1190-0620

Dear Mr. Carlson:

We have audited the City and County of San Francisco Department of Public Works' (DPW) Indirect Cost Rate Proposal (ICRP) for the fiscal year ending June 30, 2007, to determine whether the ICRP is presented in accordance with the Office of Management and Budget (OMB) Circular A-87 and the Department of Transportation's (Department) Local Programs Procedures (LPP) 04-10. The DPW management is responsible for the fair presentation of the ICRP. DPW proposed indirect cost rates as follows:

| <i>Rate Type</i> | <i>Effective Period</i> | <i>Rate *</i> | <i>Applicable To</i> |
|--------------------------|-------------------------|---------------|--|
| Fixed with carry forward | FY 2006-2007 | 124.80% | Bureau of Architecture |
| | FY 2006-2007 | 92.65% | Bureau of Building Repair |
| | FY 2006-2007 | 116.61% | Bureau of Engineering |
| | FY 2006-2007 | 90.93% | Bureau of Street Environmental Services |
| | FY 2006-2007 | 168.21% | Bureau of Street and Sewer Repair |
| | FY 2006-2007 | 122.76% | Bureau of Construction Management |
| | FY 2006-2007 | 119.70% | Bureau of Street-Use and Mapping |
| | FY 2006-2007 | 104.19% | Bureau of Urban Forestry |

*Base: Total direct salaries and wages.

Our audit was conducted in accordance with the Performance Standards set forth in the *Government Auditing Standards* issued by the Comptroller General of the United States of

America. The audit was less in scope than an audit performed for the purpose of expressing an opinion on the financial statements of the DPW. Therefore, we did not audit and are not expressing an opinion on the DPW's financial statements.

The standards require that we plan and perform the audit to obtain reasonable assurance about whether the data and records reviewed are free of material misstatement, as well as material noncompliance with fiscal provisions relative to the ICRP. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the data and records reviewed. An audit also includes assessing the accounting principles used and significant estimates made by the DPW, as well as evaluating the overall presentation.

The accompanying ICRP was prepared on a basis of accounting practices prescribed in the OMB A-87 and the Department's LPP 04-10, and is not intended to present the results of operations of the DPW in conformity with generally accepted accounting principles.

The scope of the audit was limited to select financial and compliance activities. The audit consisted of a recalculation of the ICRP, a comparison of the ICRP to single audit reports for the fiscal year ended June 30, 2006, and inquiries of DPW personnel. The audit also included tests of individual accounts to the general ledger and supporting documentation to assess allowability, allocability and reasonableness of costs based on a risk assessment and an assessment of DPW's internal control system as of April 11, 2007. Financial management system changes subsequent to this date were not tested and, accordingly, our conclusion does not pertain to changes arising after this date. We believe that our audit provides a reasonable basis for our conclusion.

Because of inherent limitations in any financial management system, misstatements due to error or fraud may occur and not be detected. Also, projections of any evaluation of the financial management system to future periods are subject to the risk that the financial management system may become inadequate because of changes in conditions, or that the degree of compliance with the policies and procedures may deteriorate.

The draft audit findings and recommendations were communicated via email to DPW on June 30, 2008, and are detailed below along with DPW's response and our analysis. A copy of DPW's response is attached. See Attachment 1.

AUDIT RESULTS

Based on audit work performed, DPW's ICRP for the fiscal year ended June 30, 2007, is presented in accordance with the OMB Circular A-87 and the Department's LPP 04-10. The approved indirect cost rates are as follows:

| | Fiscal year 2006/2007 |
|---|-----------------------|
| Bureau of Architecture | 124.80% |
| Bureau of Building Repair | 92.65% |
| Bureau of Engineering | 116.61% |
| Bureau of Street Environmental Services | 90.93% |

| | |
|-----------------------------------|---------|
| Bureau of Street and Sewer Repair | 168.21% |
| Bureau of Construction Management | 122.76% |
| Bureau of Street-Use and Mapping | 119.70% |
| Bureau of Urban Forestry | 104.19% |

The base is total direct salaries and wages. The approval is based on the understanding that a carry-forward provision applies and no adjustment will be made to previously approved rates.

Finding 1

For fiscal year 04/05 the DPW billed to the Department for project STPL-5934 (112) overhead costs of the City and County of San Francisco Department of Parking and Traffic (DPT). The DPT does not have an approved cost allocation plan for fiscal year 04/05.

OMB Circular A-87 Attachment A (C)(3)(d) requires that *“where an accumulation of indirect costs will ultimately result in charges to a Federal award, a cost allocation plan will be required.”* OMB Circular A-87 Attachment E(D)(1)(a) further states that *“all departments or agencies of the governmental unit desiring to claim indirect costs under Federal awards must prepare an indirect cost rate proposal and related documentation to support those costs. The proposal and related documentation must be retained for audit in accordance with the records retention requirements contained in the Common Rule.”*

The LPP 04-10 Chapter 5.2, Page 5-4, Indirect Costs states that *“should the local agency seek reimbursement of their indirect costs, they must receive an Approval Letter of Indirect Costs Rate for the fiscal year involved from Caltrans’ Audits and Investigations prior to billing for indirect costs.”* Our testing identified that the DPW was subsequently reimbursed by the Department on invoice CH #2654, project STPL-5934(112), for unallowable indirect costs in the amount of \$2,084.18.

Recommendation

The DPW should reimburse the Department \$2,084.18 in unallowable indirect costs billed on invoice CH #2654 to project STPL-5934 (112).

The DPW should also review all other invoices previously billed to the Department to determine if additional unallowable overhead costs were billed. All identified unallowable costs billed to the Department should be reimbursed.

Response of Auditee

DPW disagrees with this finding. The costs billed are otherwise eligible costs determined to be unallowable solely due to a timing technicality. DPT’s fiscal year 04/05 ICRP has been submitted to Caltrans and is pending approval.

Analysis of Response

The DPT ICRP had not been submitted to the Department for approval prior to this audit. LPP 04-10 requires the indirect costs to be approved “prior to billing.” The finding and recommendation remain as the DPT ICRP has not been approved as of this report date and it

is unknown whether the final approved rate will be the same as the unapproved rate used to bill the Department.

The Department's Audits & Investigations will follow-up on the DPW's review of other invoices and any identified unallowable costs during the next ICRP audit.

Finding 2

In our review of the carryforward, we discovered that equipment purchases (vehicles, street sweeper, and computer equipment) costing over \$5,000 were expensed as overhead costs in the year they were purchased. While the equipment was properly capitalized and depreciated by the Controller for financial purposes, the DPW chose to expense the entire amount of the equipment costs for the compilation of the ICRP.

We also found that the DPW included the cost to replace their HVAC system in the indirect cost pool as maintenance expense. The revised contract amount to replace the HVAC system was \$1,368,591.00. The materiality of the cost lends to the assertion that it should be capitalized as an asset, and depreciated over its useful life.

OMB Circular A-87 Attachment B (15) (a)(1) explains "*Capital Expenditures*" means *expenditures for the acquisition cost of capital assets (equipment, buildings, land), or expenditures to make improvements to capital assets that materially increase their value or useful life.*"

"(2) *'Equipment'* means an article of nonexpendable, tangible personal property having a useful life of more than one year and an acquisition cost which equals or exceeds the lesser of the capitalization level established by the governmental unit for financial statement purposes, or \$5000."

(b) "(5) *Equipment and other capital expenditures are unallowable as indirect costs. However, see section 11, Depreciation and use allowance, for rules on the allowability of use allowances or depreciation on buildings, capital improvements, and equipment. Also, see section 37, Rental costs, concerning the allowability of rental costs for land, buildings, and equipment.*"

The approved ICRP rates were adjusted for the unallowable costs.

Recommendation

The DPW should not include equipment costs or capital improvement project costs as overhead expense. These costs should be capitalized and then recovered using one of the methods defined in OMB Circular A-87. The recovery methods allowed are: use allowances, usage rates, or depreciation.

Response of Auditee

Auditee agreed with the finding and revised the ICRP accordingly.

Analysis of Response

Finding remains.

Finding 3

The DPW used indirect costs recovered through billings in the carryforward calculation of both the Bureau overhead rates and the DPW administration overhead rates. LPP 04-10 Exhibit 5-I Section II C requires that *"When the actual costs for this period are determined either by the grantee's Single Audit or if a Single Audit is not required, then by the grantee's audited financial statements any differences between the application of the fixed rate and actual costs will result in an over or under recovery of costs."* This is calculated as follows: (Direct Salaries * Approved Fixed Rate = Approved Recoveries. Actual Indirect Costs – Approved Recoveries = over or under recovery of costs.) Instead of the "Approved Recoveries," DPW used actual recoveries in this calculation.

The carryforward calculations were not in compliance with LPP 04-10. The carryforward amounts were subsequently recalculated and the rates adjusted prior to approval.

Recommendation

The DPW should calculate the carryforward on all future ICRPs as shown in LPP 04-10. The methodology involves applying the approved indirect cost rate to the related actual direct labor to determine the potential recovered costs.

Response of Auditee

Auditee agreed with the finding and revised the ICRP accordingly.

Analysis of Response

Finding remains.

Finding 4

Per our testing of an interdepartmental transaction for services provided to DPW for toxic waste and hazardous material services, we determined the City and County of San Francisco Department of Public Health (DPH) billed the DPW an unsupported 25 percent mark-up on non-labor costs. The DPH costs with the unsupported 25 percent mark-up, were included in the DPW general administration cost pool.

OMB Circular A-87 Attachment A (c) (1) describes the *"factors affecting allowability of costs. To be allowable under Federal awards, costs must meet the following general criteria: (j) Be adequately documented."* 49 CFR 18.20 (b) (6) *"Source Documentation. Accounting records must be supported by such documentation as cancelled checks, paid bills, payrolls, time and attendance records, contract and subgrant award documents, etc."*

The DPW could not provide documentation to support the 25 percent mark-up. Unsupported costs are unallowable and should be excluded from the indirect cost pool. For this fiscal year no adjustment was made to the DPW indirect cost pool due to the immateriality of the costs tested.

Recommendation

The DPW should ensure that future ICRPs submitted for approval only include costs that can be supported and are allowable per OMB Circular A-87. This includes removing any unallowable and unsupported costs from the actual indirect costs calculated for fiscal year 06/07 to be used in the carryforward in the following fiscal year 08/09 ICRP submittal.

Response of Auditee

Auditee agreed with the finding and revised the ICRP accordingly.

Analysis of Response

Finding remains.

Finding 5

The DPW included mandatory fringe benefits and paid time-off for direct labor as indirect costs. OMB Circular A-87, Attachment E, (B) (2), *"Indirect cost rate" is a device for determining in a reasonable manner the proportion of indirect costs each program should bear. It is the ratio (expressed as a percentage) of the indirect costs to a direct cost base."*

Direct costs should not be allocated to projects using the indirect cost rates. Direct costs should be charged directly to the project that incurs the costs. The direct costs were ultimately removed from the ICRP.

Recommendation

Fringe benefits and paid time off relating to direct salaries should be billed to the Department as direct project costs.

Response of Auditee

Auditee agreed with the finding and revised the ICRP accordingly.

Analysis of Response

Finding remains.

This report is intended solely for the information of DPW, Department Management, the California Transportation Commission, and the Federal Highway Administration (FHWA). However, this report is a matter of public record and its distribution is not limited.

Mr. Robert J. Carlson
September 12, 2008
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Please retain the approved Indirect Cost Rate Plan for your files. Copies were sent to the Department's District 04, the Department's Division of Accounting, and the FHWA. If you have any questions, please contact Kesh Braeger, Auditor at (916) 323-7886.



MARY ANN CAMPBELL-SMITH
Chief, External Audits

c: Brenda Bryant, FHWA
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Robert Carlson, Deputy Director

July 29, 2008

Maryann Campbell-Smith, Chief, External Audits
Department of Transportation
Audits and Investigations
1304 O Street, Suite 200
P.O. Box 942874-MS 2
Sacramento, CA 94274

Re: San Francisco, California FY 2007 Indirect Cost Plan

Dear Ms. Campbell-Smith:

The City and County of San Francisco has received the FY 2007 Indirect Cost Plan Audit findings and we thank you for the opportunity to respond. We look forward to the conclusion of the ICP audit and approval of the Fiscal Year 2007 rates.

The Department of Public Works' (DPW) response to the audit findings is enclosed.

Sincerely,

A handwritten signature in black ink, appearing to read "Robert Carlson", written over a horizontal line.

Robert Carlson, Deputy Director
Department of Public Works
City and County of San Francisco

Attachment

**CITY AND COUNTY OF SAN FRANCISCO
DEPARTMENT OF PUBLIC WORKS
FY 2007 INDIRECT COST PLAN AUDIT RESPONSES**

Finding 1

The City and County of San Francisco-DPW billed the Department on project STPL-5934 (112) for overhead costs of the Department of Parking and Traffic for FY 04/05. The Department of Parking and Traffic does not have an approved cost allocation plan for FY 04/05.

OMB requires that *"where an accumulation of indirect costs will ultimately result in charges to a Federal award, a cost allocation plan will be required."* Attachment (E)(D)(1)(a) further states that *"all departments or agencies of the governmental unit desiring to claim indirect costs under Federal awards must prepare an indirect cost rate proposal and related documentation to support those costs. The proposal and related documentation must be retained for audit in accordance with the records retention requirements contained in the Common Rule."*

The LPP 04-10 requires that *"should the local agency seek reimbursement of their indirect costs, they must receive an Approval Letter of Indirect Costs Rate for the fiscal year involved from Caltrans' Audits and Investigations prior to billing for indirect costs."* Our testing identified that the City and County of San Francisco-DPW was subsequently reimbursed by the Department for unallowable indirect costs in the amount of \$2,084.18.

Recommendation:

The City and County of San Francisco-DPW should reimburse the Department \$2,084.18 in unallowable indirect costs billed on invoice CH# 2654 on project STPL-5934 (112).

The City and County of San Francisco-DPW should review all other invoices billed to the Department on all projects to determine if additional unallowable overhead costs were billed on those invoices. All identified unallowable costs billed to the Department should be reimbursed.

The Department's Audits & Investigations will follow-up on the DPW's review of other invoices and any identified unallowable costs during the next ICAP audit.

Response of Auditee

We disagree with this finding. The costs billed are otherwise eligible costs determined to be unallowable solely due to a timing technicality. DPT's FY 2005 ICP has been submitted to Caltrans and is pending approval.

Finding 2

In our review of the carry-forward, we discovered that equipment purchases (vehicles, street sweeper, and computer equipment) costing over \$5,000 are being expensed as overhead costs in the year they are purchased. While the equipment is properly capitalized and depreciated by the Controller for financial purposes, the DPW chose to expense the equipment costs for the compilation of the Indirect Cost Plan.

We also noticed that the City and County of San Francisco DPW included the replacement of an HVAC system as maintenance expense in the indirect cost pool. The revised contract amount to replace the HVAC system was \$1,368,591.00. The materiality of the cost lends to the assertion that it should be capitalized as an asset, and depreciated over its useful life.

OMB Circular No. A-87 Attachment B (15) (a)(1) explains "*Capital Expenditures*" means *expenditures for the acquisition cost of capital assets (equipment, buildings, land), or expenditures to make improvements to capital assets that materially increase their value or useful life.*"

"(2) 'Equipment' means an article of nonexpendable, tangible personal property having a useful life of more than one year and an acquisition cost which equals or exceeds the lesser of the capitalization level established by the governmental unit for financial statement purposes, or \$5000."

(b) "(5) Equipment and other capital expenditures are unallowable as indirect costs. However, see section 11, Depreciation and use allowance, for rules on the allowability of use allowances or depreciation on buildings, capital improvements, and equipment. Also, see section 37, Rental costs, concerning the allowability of rental costs for land, buildings, and equipment." The approved ICAP rates were adjusted for the unallowable costs.

Recommendation

The City and County of San Francisco-DPW should not include the equipment costs or capital improvement projects as overhead expense. They should capitalize the equipment and capital improvement projects, and use one of the methods allowed in OMB to recover its costs. The methods allowed are recovery through use allowances, usage rates, or depreciation.

Response of Auditee

We agree with this finding and have revised the ICP accordingly.

Finding 3

The City and County of San Francisco- DPW used actual recoveries in the carry-forward calculation of both the Bureau overhead rates and the DPW administration overhead rates.

LPP 04-10 requires that *"When the actual costs for this period are determined either by the grantee's Single Audit or if a Single Audit is not required, then by the grantee's audited financial statements any differences between the application of the fixed rate and actual costs will result in an over or under recovery of costs."* The carry-forward calculations were incorrect and not in compliance with LPP 04-10. Therefore, the carry-forward amounts were recalculated and the rates adjusted.

Recommendation

The City and County of San Francisco-DPW should calculate the carry-forward on all future ICAPs as shown in LPP 04-10. The methodology involves applying the approved indirect cost rate and applying it to the related actual direct labor to determine the potential recovered costs.

Response of Auditee

We agree with this finding and have revised the ICP accordingly.

Finding 4

During a review of the indirect costs included in the indirect cost pool for DPW general administration, testing was performed on several of the costs included. Several of the large balances tested were interdepartmental transactions for services performed for the DPW by other departments in the City and County of San Francisco. We reviewed one of many invoices billed by the Department of Public Health (DPH) to the DPW general administration for toxic waste and hazardous material services. The DPH invoice contained non-labor costs with a 25% mark-up.

49 CFR 18.20 (b)(6) "*Source Documentation. Accounting records must be supported by such documentation as cancelled checks, paid bills, payrolls, time and attendance records, contract and subgrant award documents, etc.*" DPW could not provide documentation to support the 25% mark-up. Unsupported costs are unallowable and should be excluded from the indirect cost pool. For this fiscal year no adjustment was made to the DPW indirect cost pool due to the immateriality of the costs tested.

Recommendation

The City and County of San Francisco-DPW should ensure that the future ICAPs submitted for approval only include costs that can be supported and are allowable per OMB A-87.

Response of Auditee

We agree with this finding and will work to ensure future ICAPs submitted only include allowable costs.

Finding 5

The DPW included mandatory fringe benefits and paid time-off for direct labor in the indirect cost rate proposal. OMB A-87, Attachment E, (B) (2), "*Indirect cost rate*" is a device for determining in a reasonable manner the proportion of indirect costs each program should bear. It is the ratio (expressed as a percentage) of the indirect costs to a direct cost base. Direct costs should be charged directly to the project that incurs the costs. The costs can not be allocated to all projects by using the indirect cost rates. Therefore, the approved indirect rates of DPW were adjusted by the removal of the mandatory fringe benefits and paid time-off for direct labor.

Recommendation

The DPW should only include indirect costs in the indirect cost rate proposals.

Response of Auditee

We agree with this finding and have revised the ICP accordingly.